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**March 13, 2006**

**AGENDA ITEM 8b**

**TO: MEMBERS OF THE INVESTMENT COMMITTEE**

I. **SUBJECT**: Review of Internal Relational Program

II. **PROGRAM:** Global Equity

III. **RECOMMENDATION:** Information Item

IV. **ANALYSIS:**

**Executive Summary**

At the November 14, 2005 meeting, the Investment Committee directed staff to conduct a comprehensive review of the Internal Relational Program (the "Program"). Staff has completed its review and seeks input from the Committee on a proposed expansion of the current Investment Policy parameters for the Program. The current Policy parameters are as follows:

- Staff is responsible for presenting potential co-investment partners to the Investment Committee before executing an agreement with the partner.
- The Internal Relational Portfolio (the "Portfolio") is not to exceed $500 million on a cost basis without prior approval of the Investment Committee.
- Co-investment opportunities are limited to U.S. (in partnership with Relational Investors LLC) and European (in partnership with Knight Vinke Asset Management) publicly traded equity securities.

Staff's proposed expansion would include amending the current Policy parameters to read as follows:

- Delegation to staff to execute a co-investment agreement with Corporate Governance external money managers that have demonstrated at least a one year performance record in excess of the manager's performance benchmark.

- The maximum allocation of capital for co-investment in Corporate Governance external money manager partnerships is equal to 100% of the current capital commitment to a specific manager, not to exceed 20% of the Corporate Governance Program market value.
- The maximum allocation of capital to any specific publicly traded security is not to exceed 10% of the CalPERS Corporate Governance Program market value.
- The Senior Investment Officer shall have authority to make investment decisions up to 5% of the value of the Corporate Governance Program. The Chief Investment Officer shall have authority to make investment decisions that are greater than 5% of the value of the Corporate Governance Program.
- Co-investment opportunities can be sourced from both U.S. and non-U.S. publicly traded securities.

CalPERS' Corporate Governance staff has increased its investment management skills and experience since the inception of the Program in 2002. Staff believes its experience and success with the Program to date supports the expansion of a Portfolio that capitalizes on inefficiently priced global co-investment opportunities. Currently, the Portfolio can only invest in U.S. with Relational Investors LLC and select European co-investment opportunities with Knight Vinke Asset Management. Through an expansion of the Program, global co-investment opportunities would be sourced from current external corporate governance investment managers with a demonstrated record of successfully managing a portfolio currently in the CalPERS Corporate Governance Program.

Since its inception in 1996, CalPERS' Corporate Governance Program has been one of the best sources of alpha generation in the Total Fund. The Program albeit still in an early stage is an investment strategy that has outperformed its benchmark by 18.20 percent since inception through December 2005.

Through a larger opportunity set for co-investment, staff should be able to produce a greater contribution to the Total Fund's risk adjusted rate of return. Staff proposes this be accomplished through the management of a co-investment portfolio that is anticipated to outperform the underlying co-investment manager's portfolio. Portfolio risk should be reduced through diversification derived from an increase in the number of holdings in the Portfolio and broader geographic market exposure. Finally, through the Portfolio with the initial manager staff has demonstrated the ability to outperform the benchmark with lower costs to the Total Fund as compared to the cost of having the assets externally managed. Staff expects this cost benefit to continue to accrue to the Total Fund after approval of the expanded parameters for the management of the Program.

Subject to feedback and direction from the Investment Committee, staff will return at a later date with a recommendation.

**Background**

At the November 13, 2001 meeting, the Investment Committee approved staff's recommendation to invest $500 million in the CalPERS' Internal Relational Program (Attachment 1). The Program involves CalPERS partnering with external corporate governance investment managers whereby staff and the manager work together to use additional capital and experience to capitalize on opportunities for excess returns. Since inception, the Portfolio has consisted of investments resulting from CalPERS' partnership with Relational Investors, LLC. The partnership with Relational Investors, LLC has resulted in three co-investments in the Portfolio. Table 1 shows the positive performance comparison for the Portfolio since inception. It should be noted that this performance was generated primarily by one security. Staff believes the experience it has accumulated in partnership with Relational Investors, LLC and the positive performance comparison warrant the expansion of the parameters for the Portfolio with the expectation of making a greater contribution to maximizing the value of the Program to the Total Fund.

Table 1

Performance of the Internal Relational Program

| | 1 Year | 2 Year | 3 Year | Since Inception* |
|---|---|---|---|---|
| Internal Relational Portfolio | 25.24% | 29.55% | 30.77% | 33.05% |
| Benchmark | 6.11% | 8.89% | 15.74% | 14.85% |
| Value Added | 19.13% | 20.66% | 15.03% | 18.20% |

SSB methodology is CFA Institute compliant.
All figures are net of all fees for periods ending December 31, 2005
Inception Date: November 2002.
*Note that from inception to August 3, 2005, the portfolio held only one security.

**Review of Internal Relational Program**

Current policy limits investments in the Portfolio to US publicly traded securities and select European publicly traded securities. Staff seeks input from the Committee on the concept of amending policies that govern the Portfolio to permit global co-investments along side existing successful corporate governance partners to reflect an increase in the number of corporate governance investment managers and a greater geographical diversification of the Corporate Governance Program. Table 2 shows current corporate governance investment managers and the resulting global diversification of the Corporate Governance Program.

Table 2

| Investment Manager | Committed Capital ($mm) | Geographic Mandate |
|---|---|---|
| Relational Investors, LLC* | 1,400 | United States |
| Shamrock | 200 | United States |
| New Mountain Capital | 200 | United States |
| Blum Capital | 125 | United States |
| Hermes Asset Management | 100<br>200 | Europe<br>United Kingdom |
| Active Value | 350 | Europe |
| Knight Vinke Asset Management** | 600 | Europe |
| SPARX | 400 | Japan |
| Taiyo Pacific Partners | 300 | Japan |

*Includes $397.8 million in the Internal Relational Portfolio
**Includes $300 million approved for co-investment

Table 3 demonstrates the good performance of the external corporate governance managers.

Table 3

Performance of the External Corporate Governance Program

| | 1 Year | 2 Years | 3 Years | 5 Years | Since Inception |
|---|---|---|---|---|---|
| Corporate Governance Managers | 22.22% | 24.95% | 29.86% | 14.77% | 17.42% |
| Benchmark | 19.11% | 17.80% | 23.09% | 5.80% | 5.90% |
| Value Added | 3.11% | 7.15% | 6.77% | 8.97% | 11.52% |

SSB methodology is CFA Institute compliant.
All figures are net of all fees for periods ending December 31, 2005.
Inception Date: January 1999

## **Investment Decision Making Process**

Staff has developed a successful investment process to govern the way co-investments are made in the Portfolio. Staff proposes CalPERS external corporate governance investment managers with at least a one year performance record in excess of their performance benchmark will be the source of ideas for potential co-investments. Companies that are candidates for co-investment will have the following characteristics:

- Considered one of the best ideas in the manager's portfolio
- An underperforming security and company
- Stock price is selling below the embedded intrinsic value
- Manager has a strategy in place to unlock the intrinsic value
- Holding additional shares will help the corporate governance managers effect the desired operational and governance changes.

Upon receipt of a co-investment idea from an external corporate governance investment manager, staff will conduct research and analysis to be used in the evaluation of each proposed co-investment. Staff will consistently conduct due diligence using the following steps:

1. Conduct a complete review of all documentation provided by the external corporate governance manager acting as the source for the co-investment idea. The purpose of this step is to understand the investment case being made by the manager, gain knowledge about the strategy for unlocking value embedded in the company as well as assess the potential risk and reward associated with the proposed co-investment.

2. Assess the incremental benefit to the manager's strategy of CalPERS taking a co-investment position. The co-investment strategy must have merits beyond giving the manager capital in their original strategy.

3. Apply the CalPERS Focus List screening criteria to analyze the company under consideration. This process will allow staff to incorporate an additional perspective for evaluating the opportunities to improve the company's corporate governance practices, operation and financial performance and assess potential improvements in these factors.

4. CalPERS Risk Management system will be used to assist in identifying the impact the proposed co-investment will have on the risk characteristics for the Internal Relational Portfolio and the Total Fund.

5. The Senior Investment Officer for Global Equity and Senior Portfolio Manager-Corporate Governance will incorporate the recommendation from the external investment manager, research provided to staff by the external investment manager, industry analysis, the Focus List Program screening process and input from the CalPERS Risk Management System to make an investment decision affecting the holdings in the Internal Relational Portfolio. All portfolio purchases up to 5% of the Corporate Governance Program value must be approved by the Senior Investment Officer for Global Equity.  Any purchase in excess of 5% of the value of the Corporate Governance Program must be approved by the Chief Investment Officer.

6. Portfolio sell decisions can be made by either the Senior Investment Officer for Global Equity or the Senior Portfolio Manager-Corporate Governance.

## Document Retention

All documentation for a proposed and actual co-investment will be maintained in the Corporate Governance Office for three years. After three years all documentation will be moved to an offsite location. Documents retained will include and not be limited to (1) research received from the external manager proposing the co-investment, (2) industry analysis report, (3) company report consistent with the Focus List process, (4) research reports received from a third party, (5) reports from the CalPERS Risk Management System, and (6) letter agreement executed by the CalPERS Legal office.

## Letter Agreements

A Letter Agreement for each co-investment will be executed between the external corporate governance manager and the CalPERS Legal office before trading in the stock of the proposed co-investment can begin. The Letter Agreement notes the specific terms and conditions for the co-investment relationship between CalPERS and the external corporate governance investment manager. Specifically, the Letter Agreement will identify the proposed co-investment company, applicable performance objective and benchmark, method for calculating incentive fees to be paid to the investment manager if performance objectives are met and the agreement for covering expenses incurred with the co-investment which could include legal, travel, research and proxy voting. Fees associated with co-investments will generally not include the base management fee and may have a lower incentive fee reflecting the fact that there are no incremental costs to the manager as a result of CalPERS buying additional shares.

## Trading

Upon execution of a Letter Agreement, staff will coordinate trading with the external manager and execute trading in the shares of the co-investment target through the CalPERS Global Equity Trading Desk (“Desk”). Staff will notify the Desk of the co-investment target and the external manager tied to the specific co-investment to be traded. The Desk will communicate with the external manager to gain market intelligence that will contribute to achieving “best execution” for both purchases and sales of the shares of the co-investment target. For co-investment in non-US equity securities, a non-US dollar currency may be required to execute the trade. In conjunction with the Desk, staff will coordinate with the currency management staff.

Staff will use a template to provide consistent and accurate information about the co-investment target to the Desk. The template will specify the name of the co-investment target, the quantity of shares to be traded, the type of transaction to be executed, the type of order being submitted for execution (i.e. market order, limit order, etc.), and the specific currency denomination required for the trade. Information contained in the trading template will also be used by the Desk for compliance checks and to facilitate the settlement of trades. The Desk will apply all of its record management requirements to documentation pertaining to trading in co-investment.

**Compliance**

Staff has worked with CalPERS' Legal office and Wilshire Associates to identify areas of potential risk and to implement procedures to mitigate against such risk. Specifically, CalPERS Global Equity and Legal staff, external legal counsel to CalPERS and Wilshire Associates staff have reviewed CalPERS' exposure to the risk of insider trading and information. CalPERS Legal staff supports the adequacy of the existing rules and additional procedures outlined below to minimize this risk. Additional rules and procedures that are being incorporated into the Program include:

- New Letter Agreements will state that the co-investment partner will not share with CalPERS staff any non-public information from the co-investment partner.
- Existing Letter Agreements with current co-investment partners will be amended to state that the co-investment partner will not share with CalPERS staff any non-public information.
- In coordination with the legal office, CalPERS policies and procedures will be amended to include steps staff is required to take in the event staff were to receive non-public information.
- Staff will formalize the incorporation of a disclosure statement into its company engagement procedures to state that CalPERS seeks no non-public information.

In addition, staff has been working with CalPERS Legal office to develop and execute procedures governing an "Ethical Wall" between CalPERS' Focus List Program and CalPERS employees outside the Corporate Governance Office (Attachment 2). Staff will utilize the same procedures to govern the "Ethical Wall" between the Portfolio and CalPERS employees outside the Corporate Governance Office.

**Regulatory Reporting Requirements**

Due to the nature of the Program, investments will involve taking substantial incremental positions that will impact CalPERS' holdings as a percentage of the outstanding shares. At times, these investments may fall under the group rule for purposes of Securities and Exchange Commission (SEC) Regulation 13(d) and will have filing requirements under this Regulation. In the unusual circumstances where filing requirements are potentially harmful to the strategy being employed to unlock the value embedded in a company, staff in coordination with the legal office may deem it financially more advantageous to temporarily relinquish CalPERS' proxy voting rights in a co-investment.

Staff has consulted with CalPERS legal staff on this matter. An alternative to relinquishing CalPERS' proxy voting rights from time to time on specific securities is to closely monitor the size of our portfolio holdings to be sure that we stay well below the threshold that triggers SEC filing requirements and deliberately limit the size of CalPERS co-investment positions.

**Reporting to the Investment Committee**

Wilshire Associates will include the Program in its quarterly report to the Investment Committee. Each co-investment will be maintained and accounted for in a separate account tied to the external manager providing the co-investment ideas. (For example all co-investments entered into with SPARX will be captured in a separate co-investment account maintained at State Street Bank). The performance benchmark for the investment manager providing the co-investment will be the same as its respective Portfolio. This methodology will provide full disclosure and transparency to the Investment Committee on performance pertaining to each co-investment partner and their respective Portfolio. The performance for the entire Program will be the dollar-weighted average of the total return for each Portfolio associated with a specific external investment manager.

**Annual and Quarterly Reports to the Investment Committee**

In addition to reports provided on the Program to the Investment Committee by Wilshire Associates, staff will provide the Investment Committee with an annual review in the form of an annual agenda item similar to what the Committee receives regarding the MDP Program. Staff will also provide the Investment Committee with a Quarterly Review Executive Summary (Attachment 3), similar to the Risk Managed Absolute Return Strategies Program report received by the Committee.

**Allocation of Capital**

Staff proposes that the maximum allocation of capital for co-investment in partnership with an external manager is equal to 100% of the CalPERS capital commitment to that specific manager. In cases where the external corporate governance manager has a large portfolio with CalPERS, staff suggests limiting the co-investment portfolio to 20% of the market value of the CalPERS Corporate Governance Program. The current market value for the CalPERS Corporate Governance Program is $4.1 billion, currently making $820 million the approximate maximum allocation of capital that can be made to any co-investment partner.

Staff proposes that the maximum allocation of capital to any specific publicly traded security not exceed 10% of the market value of the CalPERS Corporate Governance Program. Given the nature of corporate governance investment strategies, many co-investments will involve taking substantial positions, both in terms of the dollars invested and CalPERS' holdings as a percentage of the outstanding shares. The concentrated portfolio that results from implementing this strategy is what generates the high alpha produced from this type of investing. Based on the proven performance record of the external partners in which CalPERS will enter into co-investments as well as the significant experience staff has in equity portfolio management, staff believes the proper allocation target at the specific security level not exceed 10% of the market value of the CalPERS Corporate Governance Program. The current market value for the CalPERS Corporate Governance Program is $4.1 billion, making $410 million the approximate maximum allocation of capital that can be made to any specific co-investment security.

The current capital allocation for the CalPERS Corporate Governance Program is equal to 3% of total market value of Global Equity assets plus or minus 2%. As of December 31, 2005, the market value of total Global Equity assets was $130 billion. Based on the market value of $130 billion, the maximum allocation for the CalPERS Corporate Governance Program is approximately $6.5 billion. The market value for the CalPERS Corporate Governance Program after an expansion of the parameters for the Internal Relational Program (proposed herein) would be approximately $5-6 billion, within the allowable range for capital allocated to the Corporate Governance Program.

**Comments from Wilshire Associates**

Staff has solicited the input of the Board's General Pension Consultant, Wilshire Associates. Wilshire had three principle comments: clarification as to the fees paid on the co-investment and how they would be different from the primary portfolio, clarification on insider trading prevention procedures, and differentiating adequately the value staff will add in the co-investment as opposed to just giving the manager more money. Staff has included information in this agenda item to respond to each of these issues.

**Risk Management Viewpoint (prepared by the Risk Management/Asset Allocation unit)**

**Objective:** To estimate the effect of increasing CalPERS allocation to the corporate governance active investment strategy on the risk to CalPERS portfolio.

**Summary Conclusion:** A larger investment in corporate governance funds would have essentially no effect on the forecasted total risk, though would result in higher forecasted active risk, or the potential for a greater disparity of returns between the actual plan and the policy benchmark.

**Methodology:** The proposed program increases the funding allocation of nine existing corporate governance investment managers. The strategic targets for corporate governance active investment strategy are increased from the current total approximate market value of $4 billion to a potential target totaling $6 billion. Of the $2 billion in additional funding, $700 million was allocated to US equity managers, and $1.3 billion to international equity managers. We were able to obtain and model the majority of the holdings in these accounts. The test involved assuming the same holdings and risk profiles of the individual accounts, and increasing their funding as proposed by the agenda item. In order to isolate the risk impact of this investment strategy, as opposed to affecting any changes in risk due to shifts in asset allocation, we assumed the new portfolio would be funded by a proportionate reduction in the domestic equity and international equity passive accounts. The changes in portfolio funding were configured within the context of the actual CalPERS holdings as of December 31, 2005 and run through the Barra TotalRisk model and CalPERS Risk Measurement System.

**Results:** The values presented in the table below represent the forecasted annual standard deviation of returns (%) over the next twelve months. Because of the size of the CalPERS total fund, and the diversification of investments within the total fund and within the global equity portfolio, shifting funds to this investment strategy is estimated to have minimal impact to the Fund total risk profile. The total risk of the total plan is generally determined by asset class weightings, which are assumed to not change with the adoption of this proposal. There is the potential for increased active risk, or greater difference in expected returns compared to the policy benchmark, because funds are shifted from the passive benchmark allocation to the corporate governance managers. As shown below, the active risk for global equity is forecasted to increase by approximately 50 basis points or 8%, and approximately 20 basis points or 3% for the total fund.

The corporate governance portfolios tend to be highly concentrated, holding large positions in a few securities, compared to most of CalPERS equity portfolios. This increased allocation to individual securities increases the specific risk component of active risk. Specific risk is the risk that is unique to each security as opposed to common factor risks of securities, such as industry, currency or company size. Based on the assumed increased investments in the portfolio's current holdings, active risk is also increased due to greater exposures to Japanese, European, Canadian, and UK securities. The model shows greater active risk due to increases in both the equity risk from these countries and the corresponding currency risk.

**Risk Analysis**

| TOTAL RISK | Current Plan | $2 B Corp Gov Add |
|---|---|---|
| Global Equity | 11.5% | 11.5% |
| Total Plan | 8.46% | 8.46% |
| **ACTIVE RISK** | | |
| Global Equity | 0.647% | 0.696% |
| Total Fund | 0.659% | 0.674% |

## Risks

- Reputational Risks: CalPERS' name in the corporate governance arena is important, has value, and must be used with great care.

- Volatility: The corporate governance managers and the co-investment portfolios will be highly concentrated portfolios that are more volatile and require a longer time horizon over which to judge performance.

- Concentrated portfolios: There is a higher degree of security-specific risk associated with portfolios with only a small number of positions. This risk is mitigated by the large size of the Total Fund and Global Equity overall.

- Performance: This strategy could be subject to underperformance.

## Opportunities

- Performance: Global Equity can improve its long-term performance by allocating more capital to higher alpha generating strategies such as corporate governance co-investments. Performance of the external corporate governance managers over longer time horizons is outstanding. Corporate governance managers are among the best performers in the Global Equity asset class.

- Effective Strategy: Engaging underperforming companies with activist managers has proven to be an effective strategy for CalPERS over the last 10 years. Taking co-investment positions enhances the contribution to Global Equity and Total Fund performance.

- Reputational Rewards: CalPERS further strengthens its leadership position in the governance arena by engaging underperforming companies and improving operating performance and governance practices.

- Capacity: There is scarce capacity in the best investment opportunities. Given CalPERS large size, we should allocate more capital to the best investment managers and opportunities.

- Risk Taking: Given the large size of the Global Equity asset class and the large volume of assets in the index fund, our challenge is not taking enough risk. As opportunities for co-investment arise with proven managers, staff recommends that we utilize this as an opportunity to take more risk. Prudent risk taking is an attractive investment opportunity.

**Conclusion and Summary**

Subject to feedback and direction from the Investment Committee, staff would return at a later date with a recommendation to:

1) Expand the number of co-investment managers in the Internal Relational Program potentially to managers that had at least one year of successful track record managing their external corporate governance portfolio with CalPERS.
2) Report annually to the Committee this strategy and have the Board's General Pension Consultant report on performance quarterly. In addition, staff would provide a transaction summary quarterly to the Investment Committee.
3) Provide appropriate trading and investment process procedures including buy and sell disciplines.
4) Provide for appropriate document retention.
5) Provide for appropriate compliance procedures to guard against insider trading.
6) Provide for appropriate regulatory filing procedures, including from time-to-time relinquishing CalPERS' proxy voting rights for external corporate governance managers in certain situations approved by the CalPERS Legal Office.

## V. STRATEGIC PLAN:

This item is consistent with Goal VIII, manage the risk and volatility of assets and liabilities to ensure sufficient funds are available, first, to pay benefits and second, to minimize and stabilize contributions and Goal IX, achieve long term, sustainable risk adjusted returns. This item is part of the Global Equity 2005-2006 Annual Plan.

## VI. RESULTS/COSTS:

Staff anticipates that existing resources are sufficient to support this effort.

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